

Who Owns You?

Last month, we contrasted performance investing with process investing, stating our clear preference for the latter. Unfortunately, performance investing is pushed on investors by the financial services industry. Our major problem with the financial “services” industry is that it is driven by “products” rather than services.

Stockbrokers, insurance agents and even bank employees are compensated by commissions when they initiate transactions by their customers. The only way anyone gets paid is when there is activity, even if no action is appropriate. A stock broker who bought his clients Microsoft stock 10 years ago and had them hold it made them a fortune. The broker, however, would have been fired 9 1/2 years ago for lack of “production.” To drive customer activity, there is a tremendous incentive to invent new “products” that can be sold to customers, whether they are good for them or not. We’ve always suspected that the typical insurance company consisted of two buildings, one where they invent confusing new products and the other where they create non-descriptive names for those products.

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One of our criticisms of the “performance” approach to investing is that it is emotionally destabilizing. Since customer serenity doesn’t lead to account transactions, the traditional financial services industry has a major, if unstated, bias towards emotional instability. The stockbroker or insurance agent always has a product to sell that has done better than something you own when compared over a time frame chosen by the salesperson.

Perhaps even more important, proprietary “products” result in ownership of clients because the products can’t be transferred elsewhere. Investors who own a Dean Witter mutual fund have to sell it to move their account. In a taxable account after a long bull market, the potential capital gains taxes are a substantial disincentive to move. If the broker you have worked with for years changes firms, how much are you willing to pay in taxes to follow? Likewise, insurance companies push variable annuities that levy large surrender charges if you want to move your money elsewhere. Unfortunately, most investors don’t realize the degree to which they are limiting their flexibility by being sold one of these “products” because the sales pitch focuses solely on the performance of the proprietary product *du jour*.

The perfect situation for a bank, insurance company or stock brokerage firm is to have its salespeople pushing only proprietary products. That way, they

achieve: (1) a sales commission at the time of the transaction; (2) continuing management and servicing fees; and (3) a substantial disincentive for the customer to leave, no matter how bad the servicing of the account or how many personnel changes, restructurings or added fees there are. Because of this “triple play,” the incentives provided to salespeople to sell proprietary product have traditionally been substantially higher than for alternatives. When you are sold a product, was it chosen because it fits best with your overall portfolio and objectives, or because the salesperson gets a trip to Aruba if she unloads a specified amount? Is your “service provider” promoting your interests as a client or the interests of his employer?

One advantage of not being “owned” by your financial services provider is flexibility in a rapidly changing world. When your mutual fund company or bank is bought out or merged, the acquirer relies on inertia and the proprietary characteristics of the investment products of the acquired firm to trap you, even if the investment approach for your now-merged “product” is changed and managed by some far-away person you’ve never heard of and know nothing about.

When you are sold an investment “product,” is it because the salesperson gets a trip to Aruba if he unloads a specified amount?

At Sigma, we are fanatical about a process-driven, service-oriented approach to investing. We have no ties to, and receive no commissions or trailing fees from, any provider of investment “product.” Nobody sends us on a trip if we invest client money in their mutual fund. We have no reason to choose one manager over any other manager other than a belief that it is in the best interests of our clients.

This independence, and related flexibility, was brought home to us last July when we were quoted in *The Wall Street Journal* mentioning a particular fund. The fund company, using directory assistance, called us to find out who we were -- we had never had contact with them before. If a fund manager strays from the approach for which we hired him, we don’t want personal or financial reasons standing in the way of our firing him and hiring somebody better.

If we get hit by a truck, our clients are left with a well-diversified portfolio of non-proprietary mutual funds that can be transferred almost anywhere without surrender charges or incurring taxable gains. We believe this approach is in the best interests of our clients. If you would like to learn more, call Sigma Investment Management Company.